

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM STATEMENT OF INVESTMENT POLICY

FOR DIRECTED BROKERAGE ARRANGEMENT

~~February 19, 2002~~ April 14, 2006

This Policy is effective immediately upon adoption and supersedes all previous directed brokerage policies. ~~No previous directed brokerage arrangement exists.~~

I. PURPOSE

This document sets forth the investment policy ("the Policy") for ~~the~~ Directed Brokerage Arrangement ("Arrangements"). The design of this Policy ensures that investor~~ment~~, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing participating in the Arrangements. Additionally, use of this Policy provides assurance that there is sufficient flexibility to obtain goods and services necessary for the prudent management of the fund while adhering to all regulatory standards ~~in controlling risks and capturing returns associated with this segment of the capital markets.~~

II. STRATEGIC OBJECTIVES

The strategic objective of the ~~directed brokerage arrangements~~ Arrangements is to maximize the funds available for investment research, analysis, analytical tools and transaction services by implementing industry accepted practices related to the recapture of commissions paid. ~~take advantage of the industry accepted means of funding various investment research, analysis and transaction expenses by recapturing a portion of trade commissions paid to brokers.~~

III. RESPONSIBILITIES AND DELEGATIONS

A. The **System's Investment Committee** ("the Investment Committee") is responsible for approving and amending the Policy. The Investment Committee delegates the responsibility for administering the Arrangement to the Fiscal Services Staff through the Delegation of Authority (Delegation No. 95-101).

B. The **System's Fiscal Services Staff's** ("the Fiscal Staff") duties include, but are not limited, to the following:

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1. Implementing and adhering to the Policy; Developing and recommending the Policy to the Investment Committee;
2. Maintaining a procedures manual subject to periodic reviews and updates that outline Fiscal Staff operational procedures used in implementing this Policy;
3. Implementing and adhering to the Policy; Reporting immediately to the Investment Committee all violations of the Policy with explanations and recommendations;
4. Reporting immediately to the Investment Committee all violations of the Policy with explanations and recommendations; Monitoring and reconciling commissions recaptured. Resolving variances between managers and brokers monthly;
5. The Fiscal Staff will submit quarterly a directed commission budget report to the Finance Committee and senior Investment Staff. Accounting for all funds generated from the Arrangements;
6. Evaluation and recommendation for addition or deletion of brokers from the directed brokerage arrangement; Preparing monthly external manager reports on commissions earned and;
7. Maintaining records and reports of recaptured commissions.

C. The **System's Investment Office Staff** ("the Investment Staff") shall be responsible for:

1. Developing and recommending the Policy to the Investment Committee;
2. Contracting with external investment managers who will be required to direct a portion of their normal trading activity to brokers participating in the System's Arrangements, if in the System's best interest. Investment Staff shall include directed brokerage language in the external manager contracts and negotiate with each manager the terms of their participation in the Arrangements;

3. Evaluating and recommending the addition or removal of brokers from the Arrangements:

a. Additions - The System shall authorize the use of brokerage firms ~~either that have either funded purchases of services/products in the past, or that have expressed an interest in doing so~~ participating and that are deemed to add value and choices to the System's managers available brokerage firms. The brokerage firms must be capable of providing trade transactions on a "best execution" basis. ~~Brokers may~~ shall be added ~~upon~~ pursuant to a written agreement between CalPERS and the brokerage firm initiated and approved by Investment Staff. ~~initiated by Fiscal Services Division and approved by Investment Office.~~

b. Removals – Removal from the Arrangements shall be based upon the Investment Staff's evaluation and recommendation, to include: ~~Deletions – Deletion from the System's directed brokerage arrangement shall be based upon Fiscal Staff evaluation and recommendation, to include:~~

~~(1).~~ The level of commissions generated, and;

~~(2).~~ Relative ranking compared to other participating brokers.

74. Monitoring and maintaining money manager directed brokerage records and reports. Adhering to all of the System's standard procurement procedures when making purchases with recaptured commissions. In addition, the System's procedures require Senior Investment Officers to attest to SEC Section 28 (e) eligibility.

85. Maintaining detailed files of all directed brokerage arrangements. Reviewing the activities of CalPERS' external investment managers that are participating in the Arrangements to validate that:

a. A portion of their normal trading activity is being directed to a participating broker who is returning a percentage of its commission to the System, and;

b. The investment manager is using best efforts to obtain best price and execution for securities traded for CalPERS.

9. ~~Monitoring and reconciling directed brokerage commission credits received, invoices paid, and cash payments from brokers. Account balance variances between manager and broker reports will be resolved monthly.~~

C. The System's Investment Office Staff ("the Investment Staff") shall be responsible for:

- ~~1. Updating the Directed Brokerage Approval Form.~~
- ~~2. Identifying a need for a particular service and recommending the use of directed brokerage funds for acquisition.~~
- ~~3. Supervising the use of the Service Approval form and verification and tracking of services/products received. The Service Approval form shall be completed prior to ordering services/products.~~
- ~~4. The Investment Staff shall "approve to pay" each invoice for services or products received by the Systems directed brokerage arrangement. The approval to pay shall be in writing with a signature and date~~
- ~~5. The Investment Staff shall contract with external money managers to direct a portion of their normal trading activity to brokers participating in the System's directed brokerage arrangement.~~
- ~~6. Directed brokerage requirement included in external money manager contracts. External money manager contracts shall include a requirement to participate in the System's directed brokerage arrangement.~~

IV. GENERAL – The System operates a directed brokerage arrangement as defined below.

A. Directed Brokerage Arrangement: An arrangement whereby moneyinvestment -manager trading is executed through a specific broker (or a limited list of list of participating brokers) for the benefit

of the System. In exchange for having its investment managers direct trades to a specific broker~~directing trades to a specific broker~~, the System receives a benefit from the broker in addition to execution services. ~~Directed brokerage arrangements include rebates, commission banking and commission recapture through which the broker provides the client with cash, services or pays certain obligations of the System.~~ The benefit the System receives from its Arrangements is recaptured commissions. Other forms of Arrangements exist, however the System only utilizes the commission recapture Arrangement.

Commission recapture is an arrangement whereby investment managers hired by CalPERS that have an investment strategy conducive to, and a willingness to participate in the Arrangement, direct trades to CalPERS' list of participating brokers. The broker then returns a portion of their commission to CalPERS. Under this Arrangement, the broker does not directly pay CalPERS' obligations nor does CalPERS direct the investment manager to use a specific broker. In addition, CalPERS does not pay a higher commission rate than the investment manager's other clients as a result of the Arrangements.

This is the ~~only~~ type of Arrangement the System has ever had.

B. Use of Funds: There are three criteria that must be met for recaptured commissions to receive the protection afforded by Section 28(e) of the Securities Exchange Act of 1934. At the direction of the Board, the services acquired from its Arrangements must adhere to these criteria. Services must be "brokerage and research" services, defined as follows:

- Furnishing advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing or selling securities, and the availability of securities or purchasers or sellers of securities.
- Furnishing analyses and reports concerning issues, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts.
- Effecting securities transactions and performing functions incidental thereto (such as clearance, settlement and custody, or required in connection therewith by rules of the SEC, or a self-

regulatory organization of which such a person is a member or person associated with a member, or in which such a person is a participant.

It is important to note that computer hardware and software related to investment research falls within the provisions of Section 28(e). Services considered as not providing "lawful and appropriate assistance to the investor in the performance of its investment decision-making responsibilities" such as newspapers, magazines, periodicals, government publications, office equipment, and so forth, are not protected by Section 28(e); therefore, they cannot be purchased using commissions recaptured as part of the System's Arrangements.

~~B. **Soft Dollar Arrangement:** An arrangement whereby the investment manager directs transactions to a broker, in exchange for which the broker provides brokerage and research services to the investment manager. Soft dollar arrangements include proprietary and third party research arrangements but do not include directed brokerage arrangements.~~

~~— The System has never had a soft dollar arrangement because these are only available to money managers.~~

~~— Soft dollar arrangements are the only type of arrangement for which Section 28(e) of the Securities Exchange Act of 1934 is applicable and enforceable (against the investment manager) by the Securities and Exchange Commission. Although the Securities and Exchange Commission Section 28(e) applies to soft dollar arrangements only, it is the Board's intent to incorporate and follow these provisions in their directed brokerage program.~~

~~C. **Section 28(e): Legal Authority (28(e)) IS REFERENCED SEVERAL TIMES IN THIS DOCUMENT; THEREFORE THE "LEGAL AUTHORITY" IS INCLUDED EVEN THOUGH IT ONLY APPLIES TO SOFT DOLLAR ARRANGEMENTS AND THE SYSTEM IS OPERATING A DIRECTED BROKERAGE PROGRAM).**~~

~~"Soft dollar" arrangements are permitted under the authority of Section 28(e) of the Securities Exchange Act of 1934. (15 U.S.C. sec. 78bb). This section provides that "No person . . . in the exercise of investment discretion with respect to an account shall be deemed~~

~~to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to June 4, 1975, solely by reasons of his having entered into a soft dollar arrangement. The services provided to a fiduciary for soft dollar agreements must satisfy three criteria in order to receive protection under Section 28(e):~~

~~Services must be "provided" by the broker, meaning that the broker must actually select or arrange for the services.~~

~~1. Services must be provided to an entity with investment discretion (not applicable to the System because discretion is delegated to money managers).~~

~~2. Services must be "brokerage and research" services, defined as follows:~~

~~a. Furnishing advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing or selling securities, and the availability of securities or purchasers or sellers of securities.~~

~~b. Furnishing analyses and reports concerning issues, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts.~~

~~c. Effecting securities transactions and performing functions incidental thereto (such as clearance, settlement and custody), or required in connection therewith by rules of the SEC, or a self-regulatory organization of which such a person is a member or person associated with a member, or in which such a person is a participant.~~

~~It is noted that computer hardware and software related to investment research also falls within the provisions of Section 28(e). Services considered as not providing "lawful and appropriate assistance to the investor in the performance of its investment decision making responsibilities" such as newspapers, magazines, periodicals, government publications, office equipment, and so forth, are not protected by Section 28(e); therefore, they cannot be purchased using soft dollars.~~

V. POLICY

The System recognizes that the generation of commissions is inherent to the trade execution function of the investment process. ~~Directed brokerage is~~Arrangements are a widespread industry practice among pension plans to recover, recapture and use a portion of commissions generated by normal trade activity to defray expenses associated with portfolio management, in ~~defraying expenses that would otherwise have been incurred and paid for using budgeted funds.~~

~~It is the System's Policy to defray expenses as authorized in Section 28(e) of the U.S. Securities Exchange Act of 1934 by utilizing directed brokerage commissions..~~ **The System has adopted Section 28(e) for determining appropriate expenses even though this section is not legally binding upon it.**

A. Services/Products Commission Recapture

~~The controlling principle as to whether a product or service is eligible under the parameters of Section 28(e), is whether the product or service provides lawful and appropriate assistance to the System in performing investment decision-making responsibilities. This determination pivots on whether the product or service aids the investment decision-making process as opposed to the administration/operation of the Investment Office. Refer to the Directed Brokerage Permissible Research Guide for further clarification. The participating broker will transfer the recaptured commission to the System in accordance with their agreement with the investment manager. These funds shall be deposited into the Public Employee's Retirement Fund (PERF) in a portfolio maintained by the master custodian. The recaptured commissions received will be tracked by Fiscal Services staff and reported to the Finance Committee.~~

- ~~1. Only those services that are "brokerage and research" services as defined above, or investment-related computer hardware and software, may receive consideration for directed brokerage dollar purchase.~~
- ~~2. The services must be necessary, and otherwise appropriate for the System, if obtained using budgeted funds.~~
- ~~3. The value of the services must be reasonable and benefit the System only; and~~

4. ~~The services paid for under this policy are subject to competitive bidding and contract review procedures to the extent required by Board policy.~~

B. ~~Service Approval Form~~External Participants

1. Determining External Manager Participation

The Investment Staff shall determine which external investment managers are to participate in the Arrangements. The managers shall be selected in accordance with the Board's Contract and Procurement Policies. Factors included in determining the most qualified investment managers are as follows:

a. Best Execution

The ability of a manager to achieve best execution is the most important factor in the investment Staff's analysis. The costs associated with executing a trade are both implicit and explicit. The explicit cost is the commission cost associated with administering the trade (brokerage charge, stamp-tax, SEC charge, etc). Implicit costs are market impact costs and opportunity costs. The implicit costs are not transparent to a fund and difficult to measure and monitor on an ongoing basis.

b. Manager's Investment Strategy

A manager's investment strategy may or may not, lend itself to the Arrangements without jeopardizing best execution. For example, active equity and enhanced index managers as well as those that execute a large number of program or principal trades are not good candidates for participation in the Arrangements due to their trading strategies. Also, managers that trade certain types of securities such as small cap securities, emerging markets securities, thinly traded securities or trades on less liquid international exchanges generally do not participate in the Arrangements.

Managers with value and growth strategies are more deliberate in their trading and are more price sensitive in their buy and sell decisions. Both of these general practices make them good candidates for participation in the Arrangements.

The list of CalPERS' participating brokers is sufficient to provide the majority of external investment managers the ability to identify a number of brokers to utilize. The form must contain the approval of the appropriate Senior Investment Officer, Administrative Manager, and Division Chief, and must contain the following information:

1. ~~A description of the product(s) or service(s) to be obtained. Included in the description shall be an identification of any hardware or software included with the purchase and an assessment of its value to the System;~~
2. ~~Justification for the purchase, including why it is necessary and why the System cannot do without it;~~
3. ~~The product or service aids the investment decision making process consistent with Section 28(e) and the Policy.~~
4. ~~Cost of the product or service, including both one time and ongoing costs and maintenance; and~~
5. ~~The term of service for the product or service (e.g., whether it is one time only or renewable). Billing period, e.g., monthly, quarterly, yearly.~~

~~Once all the Service Approval Form sign offs are received the directed brokerage manager in the Fiscal Services Division shall prepare the appropriate letters for distribution to the service provider and the broker explaining the invoicing.~~

~~C. Use of Soft Dollar Credits~~

~~The use of soft dollar credits or cash returned to the System as a result of manager trading with brokers in the Directed Brokerage Program shall be limited to purchasing services and products for the Investment Office in accordance with the guidelines of Section 28(e) of the 1934 Securities and Exchange Act.~~

Method of Use

Fiscal Staff may elect to use either or both of the following two methods:

1. Invoice Payment Method

System invoices for Investment Office services and products may be submitted to brokers in the Directed Brokerage Program for payment from the System's Directed Brokerage account. The amount debited from the account will be the amount of the invoice multiplied by the conversion ratio in the Directed Brokerage Agreement with the broker. Balances in the System's Directed Brokerage accounts with brokers **do not** earn interest.

2. Commission Recapture

System soft dollar credits in broker accounts may be converted to cash and sent to the System. Cash returned to the System from broker soft dollar accounts shall be placed in a restricted cash account maintained by Fiscal Services for the payment of invoices for services and products required by the Investment Office. Cash in this account shall only be used for the payment of invoices in accordance with the guidelines of Section 28(e) of the 1934 Securities and Exchange Act. The amount of cash to be returned to the System shall be determined by dividing the broker soft dollar balance by the conversion ratio in the Directed Brokerage Agreement with the broker. Cash returned to the System's restricted cash account will be placed in an interest bearing account.

D. External Participants

1. Determining External Managers Participation

CalPERS shall require external managers to participate in its Directed Brokerage Program unless expressly exempted. The task of establishing a directed brokerage commission target or exempting a manager shall be conducted during the contract negotiation process. In addition, the investment staff shall also

~~evaluate whether an exempted manager would be required to pay some type of compensation directly to the directed brokerage program.~~

~~In determining whether to exempt a manager from participating in the Directed Brokerage Program, or reduce its target level of directed commissions, the Investment Staff shall evaluate the exemption request using the following factors.~~

~~a. — Best Execution~~

~~The ability of a manager to achieve best execution is the most important factor in the investment staff's analysis. The costs associated with executing a trade are both implicit and explicit. The explicit cost is the commission cost associated with administering the trade (brokerage charge, stamp tax, SEC charge, etc.). Implicit costs are market impact costs and opportunity costs. The implicit costs are not transparent to a fund and difficult to measure and monitor on an ongoing basis.~~

~~b. — Manager's Investment Style~~

~~A manager's investment style may or may not lend itself to directed brokerage without jeopardizing best execution. For example, value managers are more deliberate in their trading and are more price sensitive in their buy and sell decisions. In addition, value managers trade less often which means a lower portfolio turnover. They, generally, provide liquidity to the market and quite often trade with limit orders. Both of these general practices make them good candidates for directed brokerage mandates.~~

~~Growth managers on the other hand are not necessarily as price sensitive regarding their buys and sells since a growth manager expects a stock to appreciate in a relatively short period of time. They, generally, take liquidity from the market. In addition, the portfolio turnover of most growth managers exceeds 100%. A higher turnover increases their importance to the brokerage community, which may~~

~~allow the managers more opportunities to direct trades to their brokers.~~

~~c. Principal Trades or Large Program Trades~~

~~Due to the extensive list of brokers participating in CalPERS' Directed Brokerage Program, the majority of managers will be able to identify a number of brokers they normally utilize through the normal course of business. However, some manager's trading strategies are not suited to directing commissions. This includes but is not limited to: 1) managers that execute a large number of principal trades and program trades, and 2) managers that trade certain types of securities such as: 1) those that trade on less liquid international exchanges, 2) domestic small cap securities, 3) emerging markets, and 4) other thinly traded or relatively illiquid stocks.~~

~~d. Manager's Assets under Management~~

~~Boutique firms or new firms that do not manage a large amount of assets are less able to participate in CalPERS' Directed Brokerage Program. These firms do not have the ability to trade large volumes with the brokers; therefore it is important they pay full commission to the brokers to ensure adequate coverage and best execution.~~

~~e. External Research~~

~~For some investment managers, research received from brokers or paid through soft dollar arrangements with specific brokers is critical to their investment process. In some cases, the managers should not be forced to direct commissions since it may cannibalize the source of funds used to pay for research that is critical to the manager's ability to meet its performance objectives. If a manager does not utilize street research, it is more capable of directing a portion of their commissions for CalPERS' benefit.~~

~~f. Initial Public Offering (IPO) Participation~~

~~Manager's access to IPOs may be diminished if they are required to direct an excessive level of brokerage commissions. For some investment managers, small cap growth managers in particular, access to IPOs is a significant part of their investment strategy. In some cases, directing commissions may reduce their chances of being included in future IPOs. The importance of this factor depends on the environment for IPO's.~~

g.c. Manager's Level of Participation in Other Clients' Directed Commission Programs.

~~If a manager is not directing brokerage~~participating in Arrangements ~~for other clients and is forced to do so only for CalPERS,~~ there is a risk of disrupting their trading style and process. Forcing a manager to direct trades on behalf of CalPERS when the manager does not direct ~~that does not direct~~ for others is potentially detrimental to CalPERS' execution because the other clients' trades will be placed first in the queue to be executed. ~~Whereas,~~If CalPERS' trades will be placed second in the queue, ~~which will lead to a less than desirable execution will result~~ since the market will have likely been impacted by the first trade.

2. Managers - Reporting

The System's ~~E~~external Money Managers~~investment managers~~ shall submit a monthly report to the System's Fiscal Services Division and Investment Office no later than the 15th of the following month. This report shall be for all activity in the previous calendar month, directed brokerage commissions and all other commissions. Managers shall pre-reconcile with brokers prior to reporting to the System.

3. Brokers - Reporting

The System's participating Brokers~~brokers~~ shall submit a monthly report to the System's Fiscal Services Division and the Investment Office no later than the 15th of the following month. This report shall be for all activity in the previous calendar month, ~~directed brokerage commissions~~ recaptured

and all other commissions. Brokers shall pre-reconcile with ~~managers~~ investment managers prior to reporting to the System.

4. Broker Termination

a. ~~Broker Termination~~

CalPERS' written agreements with its participating brokers may be terminated at any time, by either party, upon written notice, for any reason. Upon the receipt of a termination notice, the broker shall promptly discontinue all services affected unless the notice specifies otherwise. ~~of a Directed Brokerage Arrangement any soft dollar debit balance the System may have with a broker shall be settled by paying the broker an amount equal to the actual invoice amounts remaining un-reimbursed by the System through commission soft dollar trading plus a reasonable rate of interest on the outstanding hard dollar balance for the period of time that the System maintained a debit balance. All checks paid to brokers for settlement of debit balances shall be payment in full.~~

All duties and obligations of CalPERS and the broker shall cease upon termination of the written agreement between them, with the exception that each party shall remain liable for any rights, obligations, or liabilities arising from activities carried on by it under the agreement prior to the effective date of termination. Brokers will be required to remit any balance due to CalPERS within thirty (30) calendar days following termination.

b. ~~Settlement of Debit or Credit Balances~~

~~If a broker requests a cash payment to eliminate a large and long term debit balance in the System's ongoing account then the payment for such debit shall be limited to an amount equal to the actual invoice amounts remaining un-reimbursed by the System. This amount plus a reasonable rate of interest on the outstanding hard dollar balance for the period of time that the System maintained a debit balance shall be paid to broker. All checks paid to brokers for settlement of debit balances shall be payment in full.~~

~~In the event a credit balance exists the balance will be exhausted either by invoices being paid by the broker or payment made to the System through the commission recapture process.~~

E. Payment Control

- ~~1. The commission paid for the service may not exceed the combined cost of the brokerage service plus the cost of the additional good or service, had they been purchased separately;~~
- ~~2. The Investment Staff shall provide a completed Service Approval Form to Fiscal. The Fiscal Staff shall record the broker's conversion ratio, expected commitment, provider of the service, and user for all soft dollar services provided.~~
- ~~3. Brokerage firms and the Fiscal Staff shall proceed ONLY upon the completion of a written directed brokerage agreement. A service approval form from Investment Staff and specific written instructions from the directed brokerage manager to the broker concerning the purpose of the research service, its cash value and the expected commissions for satisfying the commitment shall be required. The terms under which the System shall reimburse the broker shall also be included in the confirmation of the directed brokerage arrangement.~~
- ~~4. Brokerage firms and Fiscal Staff must have an "approval to pay" (a written and dated sign-off on invoices to be paid) from Investment Staff.~~

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